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Canada: Limitation on the Elimination of Double Taxation Under the Canada-Brazil Income Tax Treaty

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I. Introduction

Under its domestic law, Canada grants a foreign tax credit for any "income or profits tax" that is paid by a taxpayer for a taxation year to the government of a country other than Canada. According to the relevant provision of the Canadian *Income Tax Act*, this credit is calculated separately for any "business-income tax" and any "non-business-income tax" paid for the year to the government of each country other than Canada, and is generally limited in each case to a proportion of Canadian tax otherwise payable for the year based on the ratio of the relevant foreign source income to the taxpayer's worldwide income.[1] In addition to this domestic rule, all of Canada's tax treaties contain a provision for the elimination of double taxation like article 23B of the OECD. Model, which requires each contracting state to allow as a deduction from tax on the income of a resident of that state an amount equal to income tax paid in the other contracting state.[2]

Unlike the OECD Model, however, which limits this deduction to "that part of the income tax … as computed before the deduction is given, which is attributable … to the income … which may be taxed in that other State," almost all of Canada's tax treaties make this treaty relief subject to domestic

* CA: Tax Court of Canada (TCC), 26 May 2016, *Société générale valeurs mobilieres inc. v. The Queen*, 2016 TCC 131, [2016] 5 CTC 2152, 2016 DTC 1102.

[1] CA: Income Tax Act, R.S.C. c. 1 (5th Supp.) sec. 126 (as amended) [hereinafter ITA]. As one might expect, business-income tax is generally defined as income or profits tax paid to the government of a country other than Canada attributable to a business carried on in the other country, while non-business-income tax is generally defined as income or profits tax that is not included in business-income tax (for example, non-resident withholding taxes paid to a country other than Canada).

[2] *OECD Model Tax Convention on Income and on Capital* art. 23B(1) (26 July 2014), Models IBFD.

law by stating that the treaty provision is "subject to the existing provisions of the law of Canada … and to any subsequent modification of those provisions, which shall not affect the general principle thereof".[3] In addition, many of Canada's tax treaties with developing countries contain a tax-sparing provision that deems taxes to have been paid to the other contracting state either at a stipulated rate or at the amount that would have been payable but for an exemption or tax reduction under an incentive provided by the other contracting state.[4]

Like Canada's tax treaties with many developing countries, Canada's tax treaty with Brazil contains a tax-sparing provision, which stipulates among other things for the purpose of the elimination of double taxation provision, that "Brazilian tax shall always be considered as having been paid" at a rate of

[3] *See* e.g. *Convention between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains* art. 21(1) (8 Sept. 1978), IBFD Treaties [hereinafter *Canada-UK tax treaty*] and *Convention between Canada and the United States of America with respect ot Taxes on Income and on Capital* art. XXIV(2) (26 Sept. 1980), IBFD Treaties [hereinafter *Canada-US tax treaty*]. As a result, as Nick Pantaleo and John Ulmer have explained, these provisions do not provide independent treaty relief for double taxation as an alternative to domestic relief, except to the extent that there is "a subsequent amendment to Canadian domestic law that affects the general principle embodied in the treaty provision." N. Pantaleo & J. M. Ulmer, *Elimination of Double Taxation: Credit and Exemption Under Canada's Tax Treaties*, in *Special Seminar on Canadian Tax Treaties: Policy and Practice* 5:1-30 at 5 (B. Arnold & J. Sasseville eds., International Fiscal Association – Canadian Branch 2001). The reasons for subjecting treaty provisions for the elimination of double taxation to domestic law appear to be twofold. First, since these rules are complex and detailed and already exist in domestic law, it is easier to simply cross-reference them in tax treaties than to include separate rules that would be difficult to include in a tax treaty. Second, since these rules, unlike the distributive articles of tax treaties, are designed primarily to benefit residents, it is appropriate to refer to domestic law to accomplish this objective. *Ibid*. at 8-9.

[4] In these circumstances, the Canada Revenue Agency explains, the treaties modify the domestic requirement that the taxpayer must have "paid" tax, causing the spared taxes "to be taken into account – as if they had been paid to the foreign country – for the purposes of calculating a foreign tax credit." CA: Canada Revenue Agency, Income Tax Folio S5-F2-C1, Foreign Tax Credit , para. 1.73 (6 Feb. 2014).

20 per cent of the gross amount of interest income subject to non-resident withholding tax under article XI of the treaty.[5] Unlike all of Canada's other tax treaties, however, the elimination of double taxation provision in the Canada-Brazil tax treaty (the treaty) is not explicitly subject to Canadian domestic law – providing instead that the deduction for "income tax paid in Brazil … shall not … exceed that part of the income tax as computed before the deduction is given, which is appropriate to the income which may be taxed in Brazil."[6]

In *Société générale valeurs mobilieres inc. v. The Queen*,[7] the Tax Court of Canada addressed the interpretation of these treaty provisions, rejecting the taxpayer's argument that treaty relief should extend to Canadian tax otherwise payable on gross interest income without taking into account any expenses incurred to earn this income, and accepting the revenue department's argument that treaty relief was limited to Canadian tax otherwise payable on net interest income earned in Brazil. The decision is a model of treaty interpretation and judicial reasoning and was rightly affirmed by the Federal Court of Appeal.[8]

II. Facts of the Case

The case proceeded by way of an application under the rules of the Tax Court of Canada,[9] with the following basic facts agreed by the parties:

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[5] *Convention between the Government of Canada and the Federative Republic of Brazil for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* art. XXII(3) (4 June 1984), Treaties IBFD [hereinafter *Canada-Brazil tax treaty*].
[6] *Ibid*., Article XXII(2).
[7] CA: Tax Court of Canada (TCC), 26 May 2016, *Société générale valeurs mobilieres inc. v. The Queen*, 2016 TCC 131, [2016] 5 CTC 2152, 2016 DTC 1102 (TCC) [hereinafter *Société générale* (TCC 2016)].
[8] CA: Federal Court of Appeal (FCA), 10 Jan. 2017, *Société Générale Valeurs Mobilières Inc. v. Canada*, 2017 FCA 3 [hereinafter *Société générale* (FCA 2017)].
[9] CA: *Tax Court of Canada Rules (General Procedure)*, SOR/90-688, sec. 58(1). According to this provision: "On application by a party, the Court may grant an order

1. A Canadian resident taxpayer earns bond interest income which arises in Brazil.

2. That bond interest may be taxed by Brazil under Article XI of the Treaty.

3. The taxpayer earns interest income from other sources that is taxable in Canada.

4. The taxpayer is deemed by article XXII(3) of the *treaty* to have paid Brazilian tax equal to 20% of the bond interest arising in Brazil.[10]

Although both parties agreed that the taxpayer was entitled to a foreign tax credit under the elimination of double taxation provision, the revenue department insisted that the credit should be limited to Canadian tax otherwise payable on net interest income earned in Brazil, while the taxpayer argued that the credit should extend to Canadian tax otherwise payable on gross interest income earned in Brazil without deducting any expenses incurred to earn this income.

The taxpayer's arguments were essentially threefold: (1) that the word "appropriate" in the elimination of double taxation provision of the treaty should be interpreted differently than the word "attributable" in the OECD Model, so that treaty relief should extend to Canadian tax otherwise payable on gross interest income earned in Brazil rather than net interest income; (2) that this result was supported by the treaty's tax sparing provision, which deems tax to be paid at 20 per cent of the "gross amount" of interest income subject to non-resident withholding tax in Brazil; and (3) that this conclusion was also supported by the fact that the treaty's elimination of double taxation

that a question of law, fact or mixed law and fact raised in a pleading or a question as to the admissibility of any evidence be determined before the hearing."

[10] *Société générale* (TCC 2016), *supra* n. 7, at para. 6. That the taxpayer earned interest income from other sources that was taxable in Canada is of less importance than the fact that the taxpayer incurred expenses attributable to the bond interest arising in Brazil.

provision is not explicitly subject to Canadian domestic law – in contrast to every other Canadian tax treaty.

III. The Court's Decision

Before addressing these arguments, the court began by reviewing basic principles of treaty interpretation, referring to the Supreme Court of Canada decision in *The Queen v. Crown Forest Industries Ltd*,[11] and Article 31(1) of the Vienna Convention on the Law of Treaties (the VCLT). According to the former, the court noted, the paramount goal of treaty interpretation is "to find the meaning of the words in question" by "looking to the language used and the intentions of the parties."[12] According to the latter: "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose."[13]

The court also cited section 3 of the *Income Tax Conventions Interpretation Act*,[14] which provides that an undefined term in a tax treaty "has, except to the extent that the context otherwise requires, the meaning it has for the purposes of the *Income Tax Act* as amended from time to time," and article III(2) of the Canada-Brazil tax treaty which similarly provides that an undefined term "shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting State relating to the taxes which are the subject of this Convention."[15]

Following the guidance of these authorities, the court's analysis considered the text of the relevant provision, the broader context of other

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[11] CA: Supreme Court of Canada (SCC), 22 June 1995, *Crown Forest Industries Ltd. v. Canada*, [1995] 2 C.T.C. 64, 95 D.T.C. 5389 [hereinafter *Crown Forest* (SCC 1995)].
[12] *Ibid*. at para. 22, cited in *Société générale* (TCC 2016), *supra* n. 7, at para. 9.
[13] Cited in *ibid*. at para. 10.
[14] CA: Revised Statutes of Canada (RSC) 1985, c. I-4 (as amended), cited in *ibid*. at para. 11.
[15] Cited in *ibid*. at para. 12.

treaty provisions and domestic law, as well as the purpose of the provision in light of the parties' presumed intentions.

III.1 Text

The relevant text at issue was the second sentence of article XXII(2) of the Canada-Brazil tax treaty, which limits the deduction for income tax paid in Brazil to "that part of the income tax as computed before the deduction is given, which is appropriate to the income which may be taxed in Brazil." Although the parties agreed that the words "income tax as computed before the deduction is given" refer to Canadian income tax before the foreign tax credit ("Pre-credit Tax"), and that the words "income which may be taxed in Brazil" refer to income which Brazil may tax under the treaty – in this case, the gross bond interest subject to tax in Brazil – they disagreed about the meaning of the words "that part of the income tax … which is appropriate to" the Brazilian income.

According to the taxpayer, the word "appropriate" in this provision should be interpreted according to its ordinary meaning as "specifically fitted or suitable", such that the upper limit on the deduction for Brazilian tax would be "the Pre-credit Tax that is especially fitted or suitable to the gross interest income which may be taxed in Brazil."[16] For the revenue department, on the other hand, the word "appropriate" in this context requires a "logical connection between, or apportionment of, the Canadian income tax payable by the taxpayer on the Brazil bond income and the total Canadian income tax paid by the taxpayer on its worldwide income."[17]

The court found the revenue department's interpretation more persuasive for two reasons.

First, it noted, the French and Portuguese versions of the Canada-Brazil tax treaty – both of which are, by virtue of article 33 of the VCLT, equally authoritative and presumed to have the same meaning as the English

[16] *Ibid*. at para. 19.
[17] *Ibid*. at para. 21.

version – use the words "correspond" and "correspondante", suggesting that there had to be a relationship between the part of the Canadian tax eligible for the credit and the bond interest that was subject to tax in Brazil.[18] For this reason, the court concluded, the better meaning of the word "appropriate" in article XXII(2) "refers to a correspondence or logical connection between the part of the Canadian tax to be allowed as a credit and the Brazilian bond income."[19]

Second, it explained, since the words "the income tax as computed before the deduction is given" in article XXII(2) denote Canadian income tax before the foreign tax credit ("Pre-credit Tax"), and Canadian income tax is computed on a net basis under the *Income Tax Act*, it follows that the text of this provision, which limits the foreign tax credit to "that part of" the Pre-credit tax "which is appropriate to" the income subject to tax in Brazil, limits the credit to "the actual Canadian tax the taxpayer would otherwise pay on the Brazilian income" under the *Income Tax Act,* which is "calculated on net income."[20]

III.2 Context

Having dismissed the taxpayer's textual argument that the limitation in article XXII(2) should be interpreted to extend to Canadian tax otherwise payable on gross interest income, the court proceeded to reject the taxpayer's contextual arguments based on the reference to the "gross amount" of interest income in the tax sparing provision and the fact that the Treaty's elimination of double taxation provision is not subject to Canadian domestic law.

Regarding the first of these arguments, the court saw no reason why the tax sparing provision in article XXII(3), which deems Brazilian tax to be paid at a rate of 20 per cent of the gross amount of interest income subject to non-resident withholding tax, should affect the limitation on the foreign tax credit in article XXII(2), which is computed as that part of Canadian income

[18] *Ibid*. at paras. 22-31.
[19] *Ibid*. at para. 26.
[20] *Ibid*. at para. 34.

tax otherwise payable that is appropriate to the income that may be taxed in Brazil. On the contrary, the court concluded, since the reference to "income tax" in article XXII(2) is a reference to Canadian income tax, which is computed on a net basis, "clear language … would have been required" in order to "depart from this basic concept of Canadian tax law."[21]

The court rejected the second of these arguments on a similar basis, explaining that a limitation on the foreign tax credit to Canadian income tax otherwise payable on net interest income earned in Brazil "is implicit in the phrase 'income tax as computed before the deduction is given' which appears in Article XXII(2)."[22] Since article III(1) of the Treaty defines "tax" as "Brazilian or Canadian tax as the context requires" and the reference to "income tax" in article XXII(2) clearly means Canadian income tax, it follows that these words "import … the computational rules for determining income as set out in Part I of the *Income Tax Act*" – including in particular the requirement that income from each geographical source must be computed separately on a net basis.[23] For this reason, the court concluded, even though the Canada-Brazil tax treaty did not explicitly make the elimination of double taxation provision subject to Canadian domestic law, this result is "implicit in the phrase 'income tax as computed before the deduction is given' which appears in Article XXII(2)."[24]

III.3 Purpose

Turning to the purpose of the provision, the court began by noting that the preamble to the Canada-Brazil tax treaty declared that its purpose was "for the avoidance of double taxation on income" and that this purpose is repeated in the heading to article XXII which reads "Methods for the Elimination of Double Taxation".[25]

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21 *Ibid*. at para. 41.
22 *Ibid*. at para. 51.
23 *Ibid*. at para. 52, referring to sec. 4 ITA.
24 *Ibid*. at para. 51.
25 *Ibid*. at para. 55.

Although acknowledging that the tax sparing provision in article XXII(3) departs from this purpose by crediting Brazilian taxes that may not be paid (and does so at a generous rate of 20 per cent, which exceeds the 15 percent maximum withholding tax rate for interest under article XI(2) of the treaty),[26] the court rejected the taxpayer's argument that this provision was intended to apply in "as unrestricted a manner as possible, the result of which would be to maximally encourage the lending of funds by Canadian enterprises to Brazil."[27] On the contrary, the court held:

> It seems unlikely that the tax sparing provision was intended by either Canada or Brazil to operate to shelter not only Brazilian interest income from Canadian tax, but income from other sources unrelated to Brazil … [which] would be the effect of the [taxpayer's] interpretation in cases where the Canadian resident taxpayer incurred expenses related to the interest income arising in Brazil.[28]

For this reason, it concluded, "it would take clear language to create an incentive of the nature suggested by the [taxpayer], and such language is not present in this case."[29]

Finally, the court emphasized, the taxpayer's interpretation would be contrary to article 23B of the OECD Model and the Commentaries – the former of which limits the foreign tax credit to the part of income that is "attributable" or "correspondant" to the income which may be taxed in the other state,[30] and the latter of which explains that the "maximum deduction" permitted by this limitation "is normally computed as the tax on net income, i.e. on the income from [the source State] less allowable deductions."[31]

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[26] *Ibid*. at paras. 60-61.
[27] *Ibid*. at para. 62.
[28] *Ibid*.
[29] *Ibid*.
[30] *Ibid*. at para. 70.
[31] *Ibid*. at para. 72, citing *OECD Model Tax Convention on Income and on Capital: Commentary on Article 23B* para. 57 (11 Apr. 1977), Models IBFD. This language

Although the taxpayer argued that reference to these "supplementary means of interpretation" was questionable since Brazil is not a member of the OECD, and permissible under article 32 of the VCLT only to "confirm" a meaning already arrived at or to "establish" a meaning only where the meaning otherwise determined is "ambiguous or obscure" or "manifestly absurd or unreasonable",[32] the court held that the parties must have considered the OECD Model in drafting the Canada Brazil tax treaty,[33] so that the OECD Model and Commentaries could be regarded as part of the context for interpreting the treaty under article 31(1) of the VCLT.[34]

For these reasons as well, therefore, the court held that "the limitation described in article XXII(2) restricts the amount of the foreign tax credit that Canada is required to give to an amount equal to the actual Canadian income tax, which is calculated on the net interest income derived from Brazil."[35]

IV. Comments on the Court's Reasoning

Although the combined effect of the tax sparing provision in article XXII(3) of the Canada-Brazil tax treaty, the use of the word "appropriate" in the second sentence of article XXII(2), and the absence of language in article XXII(2) explicitly limiting the foreign tax credit to Canadian domestic law together raise legitimate questions as to the proper interpretation of the limitation on the elimination of double taxation provision in the Canada-Brazil tax treaty, the Tax Court of Canada decision in *Société générale* does an

now appears in *OECD Model Tax Convention on Income and on Capital: Commentary on Article 23B* para. 63 (26 July 2014), Models IBFD.

[32] *Ibid*. at para. 64.

[33] *Ibid*. at para. 67, explaining that "the similarities between the language used in Article XXII(3) of the *Treaty* and that found in paragraph 23B of the 1977 OECD Model is evidence that the 1977 OECD Model was considered in drafting the *Treaty*."

[34] *Ibid*. at para. 65, citing *Crown Forest* (SCC 1995), *supra* n. 11, at para. 44, concluding that "a court may refer to extrinsic materials which form part of the legal context … [including] accepted model conventions and official commentaries thereon … without the need first to find an ambiguity before turning to these materials."

[35] *Ibid*. at para. 75.

excellent job navigating these interpretive issues and concluding that article XXII(2) limits the maximum credit to Canadian tax otherwise payable on net interest income derived from Brazil.

Textually, the court was right to note that because the words “the income tax as computed before the deduction is given” in article XXII(2) refer to Canadian income tax before the foreign tax credit, it follows that a limitation to “that part of” this income tax “which is appropriate to” income that is subject to tax in Brazil limits the credit to the “actual Canadian tax” that the taxpayer would otherwise pay on the Brazilian income, which is calculated on net income. Despite the use of the word “appropriate” rather than “attributable”, therefore, the court was right to limit the credit to Canadian tax otherwise payable on net income earned in Brazil, particularly given the use of the words “correspondant” and “correspondante” in the equally authoritative French and Portuguese versions of the treaty, which confirm that there must be a logical connection between the Canadian tax and the income that is subject to tax in Brazil.

Contextually, this conclusion is consistent with the tax sparing provision in article XXII(3), which refers to Brazilian tax not Canadian tax, and with article III(1) of the treaty, which confirms that the words “the income tax that is computed before the deduction is given” refer to Canadian income tax, which is calculated on the net income from various sources, after deducting expenses incurred to earn this income. It is also consistent with the OECD Model and Commentaries and the likely purpose of the tax sparing provision which is intended to preserve tax incentives and encourage Canadian investment in Brazil, without sheltering “not only Brazilian interest income from Canadian tax, but income from other sources unrelated to Brazil as well."[36]

Following the interpretive rules of the Vienna Convention and the Supreme Court of Canada’s guidance in *Crown Forest*, the Tax Court of Canada decision in *Société générale* is a model of treaty interpretation and judicial reasoning. It is no surprise, therefore, that it was affirmed by the

[36] *Ibid*. at para. 62.

Federal Court of Appeal in a unanimous decision concluding that the Tax Court's interpretation was "the one that is most consistent with the text, the context and the purpose of the provision."[37]

V. Conclusion

Entered into in 1984 and not subject to any amendments since then, the Canada-Brazil tax treaty is one of Canada's older tax treaties – containing an extremely generous tax sparing provision and an elimination of double taxation provision that differs from all other Canadian tax treaties by not explicitly making treaty relief subject to Canadian domestic law. While the decisions in *Société générale* may limit the extent to which these provisions can be used to shelter Canadian tax, they leave open the possibility of abuse through the use of Canadian-based conduits and the routing of investments through financial institutions in Brazil,[38] and raise the broader question of whether the treaty should be renegotiated to reconsider the tax sparing provision and clarify the relationship between article XXII(2) and Canada's domestic foreign tax credit.

Although the policy of tax sparing continues to be a matter of some debate,[39] the OECD has questioned the merits of these provisions on the grounds that they provide uncertain economic benefits for developing countries, are vulnerable to taxpayer abuse, and can aggravate the potentially harmful effects of preferential tax regimes.[40] For these reasons, the Committee of Fiscal Affairs recommends that tax sparing provisions should be considered "only in regard to States the economic level of which is considerably below

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[37] *Société générale* (FCA 2017), *supra* n. 8, at para. 13.
[38] For a detailed discussion, *see* D. Toaze, *Tax Sparing: Good Intentions, Unintended Results*, 49 Can. Tax J., 879-924 (2001).
[39] *See*, e.g. L. E. Schoueri, *Tax Sparing: A Reconsideration of the Reconsideration* in *Tax, Law and Development* 106-124 (Y. Brauner & M. Stewart eds., Edward Elgar 2013).
[40] *See* paras. 75-78 *OECD Model: Commentary on Article 23B* (2014), citing the report by the OECD Committee of Fiscal Affairs, *Tax Sparing: A Reconsideration* (1998).

that of OECD member States" and carefully designed to "minimize the potential for abuse" and "discourage harmful tax competition" by "ensuring that they apply exclusively to genuine investments aimed at developing the domestic infrastructure of the source State."[41] Whether the tax sparing provision in article XXII(3) of the Canada-Brazil tax treaty satisfies these criteria seems highly unlikely.

As for article XXII(2), although the decision in *Société générale* limits the extent of the elimination of double taxation provision to Canadian tax otherwise payable on net income earned in Brazil, it seems clear that this provision is not otherwise subject to Canadian domestic rules, including specific anti-avoidance rules designed to limit the abuse of foreign tax credits.[42] For this reason, it is not clear why Canada should want to retain language that differs from every other Canadian tax treaty by failing to make the elimination of double taxation provision explicitly subject to Canadian domestic law.

For both reasons, therefore, *Société générale* might reasonably induce the Canadian revenue authorities to reconsider these aspects of the Canada-Brazil tax treaty.

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[41] *Ibid*. at para. 78.1.

[42] *See*, e.g. sec. 126(4.1) to (4.3) ITA, which are designed to prevent tax-motivated transactions designed to acquire or generate foreign tax credits without realizing an economic profit or bearing the burden of the foreign tax. For a useful discussion, *see* Toaze, *supra* n. 38, at 899-903.